China Flash

What to expect from the Shanghai Free Trade Zone

The Shanghai Free Trade Zone, which received formal approval from the State Council in August, is scheduled to become operational this Sunday, September 29. Formally termed the "China (Shanghai) Pilot Free Trade Zone", the concept has attracted attention both for its potential business impact in Shanghai, and as a catalyst for nationwide economic reforms. While details have yet to be announced (most likely on Sunday), the main elements are expected to include liberalization of trade, investment, and financial services. On the trade front, the zone is expected to reduce import tariffs and duties and to facilitate trade-related services such as commodity warehousing, international shipping, and trade finance. To spur investment, the zone is expected to facilitate approvals and to open sectors such as telecom and medical services to international participation. Finally, with respect to financial services, which have attracted most of the market attention so far, the zone is expected to become a test ground for the liberalization of interest rates and capital account opening. It remains to be seen how significant all of these initiatives will be, especially in the financial sector given the administrative difficulties in carrying out reforms on a limited geographic basis and in a way to prevent leakages to the domestic financial system. Nevertheless, given the strong support of China's new leadership, including Premier Li Keqiang himself, the zone merits close attention as a catalyst for broader national reforms, reminiscent of Shenzhen in 1978.

- **Limited geographic scope.** The Free Trade Zone encompasses 28.8 sq km, a tiny fraction of Shanghai's broad urban expanse of around 2,600 sq km. The Zone is to include four areas: Waigaoqiao Bonded Area, Waigaoqiao Bonded Logistics Park, Yangshan Bonded Port and Pudong Airport Integrated Bonded Area.
- **Trade and investment liberalization as a precursor to free trade initiatives.** An important motivation of the Free Trade Zone may be to prepare for China's eventual participation in international initiatives such as the 12-country Trans-Pacific Partnership. In particular, the Zone may serve to create momentum for reforms that have met with domestic resistance from vested interest groups, such as foreign entry into protected service sectors. In this regard, foreign investors within the zone may be given national treatment. It is also expected that administrative procedures for FDI will be streamlined.
- **It remains to be seen how far-reaching the zone's financial reforms will be.** Expectations are running high that the Free Trade Zone will be used to advance key financial reforms, including interest rate liberalization, exchange rate flexibility, and capital account convertibility. It is also expected that the zone may result in accelerated and streamlined entry for foreign bank branches and domestic private banks, although there would likely be restrictions on the activities of these branches vis-à-vis activities in the rest of the Mainland. Pending further details, we remain cautious on the extent to which the Zone will be used a test-ground for nationwide financial reforms given the practical difficulties in preventing spillovers from the zone to the domestic financial system. Rather, we would expect financial sector reforms to proceed on a gradual national basis, as they have up to this point.
- **Promoting Shanghai as an international financial center.** Beyond the zone's importance in promoting broader reforms may be the local government's interest in promoting Shanghai as a financial center. In particular, the zone is expected to enhance cross-border RMB trade settlement, for which Hong Kong has, until now, been designated as the premier offshore center. For the time being Hong Kong, with its substantial financial infrastructure, strong legal system, and international presence would appear well-placed to meet the challenges of heightened competition.

Stephen Schwartz
stephen.schwartz@bbva.com.hk
+852 2582 3218

Le Xia
xia.le@bbva.com.hk
+852-2582-3132